



Appeal of Trus-Joist Corporation

The question presented by this appeal is whether rental income and gain from the sale of certain property was apportionable business income.

Appellant manufactures building trusses. It apparently operates a single unitary business within and without California, and uses combined report procedures when filing its California franchise tax returns.

Appellant entered into a 15-year lease of real property in Cucamonga, California, with a lease term from March 1, 1966, through February 28, 1981. The lease provided an option to purchase, exercisable only during the following intervals: March through August, 1971; March through August, 1976; and September 1980 through February 1981.

The property was used in appellant's business for a short time at the beginning of the lease term, but in February 1968 it was sublet to B.M.R. Aviation, Inc., an unrelated company. The sublease apparently contained an option to purchase the property from appellant. Thereafter, the property was sublet at various times to unrelated tenants. Except for one short-term month-to-month tenancy, all of the subleases contained similar options to purchase. The original lessor, Lucas Land Co. (Lucas), acted as real estate broker, attempting to sell the property from the time appellant vacated in 1968.

Appellant finally received an offer to purchase the property in December 1976. Appellant's option period had expired in August of that year, but Lucas agreed to extend the period so that appellant could purchase the property. Appellant exercised the option and the property was simultaneously sold to the offeror.

During all the appeal years, appellant included the rental income from the property as apportionable business income on its franchise tax returns. It also reported the gain on the sale of the property as business income on its 1976 return.

Respondent determined that the Cucamonga property had been permanently withdrawn from the property factor at least as early as 1974. Therefore, it treated both the rental income and the gain on the sale as non-business income and eliminated the property from the calculation of the property factor for the appeal years.

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Since its adoption by California in 1966, the Uniform Division of Income for Tax Purposes Act (UDITPA) (Rev. & Tax. Code, §§ 25120-25139) has provided a comprehensive statutory scheme of apportionment and allocation rules to measure California's share of the income earned by a taxpayer engaged in a multistate or multinational unitary business. UDITPA distinguishes between "business income," which must be apportioned by formula, and "non-business income," which is allocated to a specific jurisdiction according to the provisions of sections 25124 through 25127 of the Revenue and Taxation Code. Business and nonbusiness income are defined in Revenue and Taxation Code section 25120 as follows:

(a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

* * *

(d) "Nonbusiness income" means all income other than business income.

The statutory definition of business income provides two alternative tests for determining the character of income. The "transactional test" looks to whether the transaction or activity which gave rise to the income occurred in the regular course of the taxpayer's trade or business. The "functional test" provides that income is business income if the acquisition, management, and disposition of the property giving rise to the income were integral parts of the taxpayer's regular business operations, regardless of whether the income was derived from an occasional or extraordinary transaction. (Appeal of Fairchild Industries, Inc., Cal. St. Bd. of Equal., Aug. 1, 1980; Appeal of New York Football Giants, Inc., Cal. St. Bd. of Equal., Feb. 3, 1977; Appeal of Borden, Inc., Cal. St. Bd. of Equal., Feb. 3, 1977.)

Capital gains and losses from sales of real property are apportioned by formula if they come within the definition of business income (Rev. & Tax. Code, § 25128), but are allocable to the state in which the property is located if they constitute items of nonbusiness income. (Rev. & Tax. Code, § 25125.) The labels

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customarily given items of income, such as rents or capital gains, are of no aid in determining whether the income is business or nonbusiness income; the gain or loss on the sale of property, for example, may be business or nonbusiness income, depending on the relation to the taxpayer's trade or business. (Cal. Admin. Code, tit. 18, reg. 25120, subd. (a) (art. 2.5).)

Respondent's regulations provide that gain or loss on the sale of property is business income

if the property while owned by the taxpayer was used in the taxpayer's trade or business. However, if such property was utilized for the production of nonbusiness income or otherwise was removed from the property factor before its sale, ... the gain or loss will constitute nonbusiness income. (See Regulations 25129 to 25131 inclusive.)

(Cal. Admin. Code, tit. 18, reg. 25120; subd. (c)(2) art. 2.5).)

Rental income is considered business income

if the property with respect to which the rental income was received is used in the taxpayer's trade or business or is incidental thereto and therefore is includible in the property factor under Regulations 25129 to 25131 inclusive.

(Cal. Admin. Code, tit. 18, reg. 25120, subd. (c)(1) (art. 2.5).)

According to these regulations, the characterization of the gain on the sale depends upon the characterization of the rental income and whether the property, while rented, was includible in the property factor. Regulation 25129 provides guidelines for determining whether property is to be included in the property factor:

(a) ... The property factor of the apportionment formula ... shall include all real and tangible personal property owned or rented by the taxpayer and used during the income year in the regular course of such trade or business. ...

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Property used in connection with the production of nonbusiness income shall be excluded from the property factor. ...

(b) . . . Property shall be included in the property factor if it is actually used or is available for or capable of being used during the income year in the regular course of the trade or business of the taxpayer. Property held as reserves or standby facilities or property held as a reserve source of materials shall be included in the factor. For example, a plant temporarily idle or raw material reserves not currently being processed are **includible** in the factor. ... Property used in the regular course of the trade or business of the taxpayer shall remain in the property factor until its permanent withdrawal is established by an identifiable event such as its conversion to the production of nonbusiness income, its sale, or the lapse of an extended period of time (normally, five years) during which the property is held for sale.

(Cal. Admin. Code, tit. 18, reg. 25129, subds. (a)-(b) (art. 2.5).)

Applying these regulations and the statutory definition of business income to the facts of this case, we can only conclude that appellant's Cucamonga property began producing nonbusiness income, and should have been withdrawn from the property factor, before 1974. Although the property was used in appellant's unitary business for a short time, beginning in 1968 it was fairly continuously leased to unrelated parties and was, at all times, held for sale.

Appellant has not shown that the property was "available for or capable of being used . . . in the regular course of [its] trade or business" at any time after March 1, 1968, as required by regulation 25129, subdivision (b), supra. No contention has been made that the property was held in reserve as a standby facility.

Appellant contends that, under certain market conditions and because of its limited option to purchase, more than the "normal" five years should be allowed while the property was held for sale before an "extended period

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of time" is considered to **have** lapsed. However, appellant has not proven that any abnormal or adverse market conditions existed. In addition, since the property was finally purchased and sold at a time when appellant's option under the lease had lapsed, we are not inclined to consider the option as a particularly limiting factor.

In any case, appellant's reliance solely on the "lapse of time" condition in regulation 25129 is misguided. That is only one way in which property may be withdrawn from the property factor. Here, the identifiable event which caused the withdrawal of the property from the property factor was the cessation of its use in the unitary business and its subletting to an unrelated entity for an extended **period of** time. (See Cal. Admin. Code, tit. 18, reg. 25129, subd. (b), Ex. (c) (art. 2.5).)

Because the property began producing nonbusiness income and should have been withdrawn from the property factor before 1974, both the rental income produced during the appeal years and the gain on the sale were correctly characterized by respondent as nonbusiness income, allocable entirely to California. Respondent's action, therefore, must be sustained.

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O R D E R

Pursuant to the views expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 25667 of the Revenue and Taxation Code, that the action of the Franchise Tax Board on the protest of Trus-Joist Corporation against proposed assessments of additional franchise tax in the amounts of \$1,129.99 and \$4,994.80 for the income years 1974 and 1976, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 1st day of August, 1984, by the State Board of Equalization, with Board Members Mr. Nevins, Mr. Dronenburg, Mr. Collis, Mr. Bennett and Mr. Harvey present.

<u>Richard Nevins</u>	, Chairman
<u>Ernest J. Dronenburg, Jr.</u>	, Member
<u>Conway H. Collis</u>	, Member
<u>William M. Bennett</u>	, Member
<u>Walter Harvey*</u>	, Member

*For Kenneth Cory, per Government Code section 7.9